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NetApp, Inc. (NTAP)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to NetApp First Quarter Fiscal Year 2020 Conference Call. My name is Latif and I will be your conference call coordinator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will be given at that time.

I will now turn the call over to Kris Newton, Vice President, Corporate Communications and Investor Relations. Please proceed, Ms. Newton.

Kris Newton

Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

Thank you for joining us on our Q1 fiscal year 2020 earnings call. With me today are our CEO, George Kurian; and CFO, Ron Pasek. This call is being webcast live and will be available for replay on our website at netapp.com.

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for the second quarter and full fiscal year 2020; our expectations regarding future revenue, profitability, shareholder return; and our ability to improve execution, gain share, and expand our sales capacity without increasing total operating expenses, all of which involve risks and uncertainty. We disclaim any obligation to update our forward-looking statements and projections.

Actual results may differ materially for a variety of reasons, including macroeconomic and market conditions; the IT capital spending environment; and our ability to expand our total available market, acquire new accounts and new buyers, expand on existing accounts, capitalize on our Data Fabric strategy, improve the consistency of our sales execution, and continue our capital allocation strategy.

Please also refer to the documents we file from time to time with the SEC and available on our website, specifically our most recent Form 10-K for fiscal year 2019 including the management's discussion and analysis of financial condition and results of operations and risk factors sections, and our current reports on Form 8-K.

During the call, all financial measures presented will be non-GAAP unless otherwise indicated. Reconciliations of the GAAP to non-GAAP estimates are posted on our website.

I'll now turn the call over to George.

George Kurian

President, Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Good afternoon, everyone. Thank you for joining us. As we discussed on our call on August 1, while I'm clearly disappointed in our weaker-than-expected top line results, the fundamentals of our business are robust and I am confident that we have the right strategy and technologies to address the market transitions to all-flash arrays, private cloud, and cloud data services. We have a strong business model as the result of the hard work we conducted to improve gross margin and cost structure over the last several years. This enables us to navigate the ongoing macroeconomic headwinds and make the strategic moves that position us well to return to growth.

We have further analyzed the dynamics of what happened in the first quarter, and they confirmed that we are seeing a combination of slowdown related to overall macro conditions and company-specific go-to-market execution issues. We continue to see pressure on deal sizes, longer sales cycles, and deferral of transactions. But as I noted on our earlier call, our underperformance is not across the board. Our APAC, Europe and U.S. Public Sector geographies were mostly on track. Even in the areas where we experienced the greatest weakness, top global accounts and the Americas, there were pockets of strength and high-performing teams. We have been very successful with some of our global accounts, but we need to expand our wallet share in others. We have deep relationships with too few of these customers, which increases our susceptibility to a slowdown in spending related to the macro.

In the Americas, roughly 40% of our districts were successful in acquiring new customers, reaching new buyers within existing customers, and effectively selling our entire portfolio, and as a result grew year-over-year. Performance across districts is inconsistent. Our sales leadership and I are committed to improving our sales execution through necessary leadership changes, better inspection and discipline, expanded account coverage, acquisition and portfolio selling.

Let me underscore the fact that we do not believe that the revenue shortfall was related to a change in the competitive environment. Our win rates remained constant and our product gross margins remained strong. In short, we need to replicate our proven areas of success by getting in front of more buyers with our full portfolio. To better capitalize on our opportunity, we will expand our sales capacity without increasing total operating expenses by continuing to make disciplined trade-offs in our spending priorities.

To that end, I'll now provide more detail on these specific steps we are taking. First, we plan to add approximately 200 primary sales resources in the next 12 months, with a focus in the Americas. We will do this without increasing the total operating expenses for the company. The new sales head count will focus on acquiring new accounts, as well as engaging new buyers and finding new opportunities in existing accounts.

Second, we will sharpen the focus of our all-flash go-to-market, including marketing sales and services, to emphasize our strong value proposition in mission-critical environments where customers continue to prioritize spending. We expect that this, combined with additional sales capacity, will return us to a position of growth in the all-flash market.

Third, now that our services are generally available in Azure and will soon be in Google, we expect to see an acceleration of Cloud Data Services revenue as their sales teams' ramp in selling our service. We continue to focus on expanding the range of use cases and deployment scenarios, and enabling the various pathways to market to sell these services.

And finally, we will scale our growth in the private cloud market through focused marketing and sales efforts. The increased sales capacity focus on reaching non-storage buyers will support this effort. We are materially stepping up our efforts to address the appropriate buyers for our private cloud and cloud data services offerings as they are different from our traditional storage buyers.

To recap, I'm confident that we can return to growth by increasing our sales capacity, adding new accounts, reaching new non-storage buyers, and selling the full portfolio. We expect that these efforts will accelerate our participation in the growing private cloud and cloud data services markets, and drive share gains. Additionally, these actions will broaden our pipeline, while lowering risks stemming from customer concentration.

In Q1, our all-flash array business inclusive of All Flash FAS, EF and SolidFire products and services declined 24% year-over-year to an annualized net revenue run rate of $1.7 billion. This comparison includes a significant amount of ELA revenue related to all-flash in Q1 a year ago that did not repeat in Q1 this year. While I'm disappointed by the performance of this part of the business, I remain confident in our competitive positioning and our opportunity for continued success. We have industry-leading guaranteed storage efficiency, the highest performance and the most complete cloud integration in the market today. And the actions we are taking to increase sales coverage and target mission-critical workloads will help return our all-flash business to growth.

Moving to our private cloud solutions. SolidFire, NetApp HCI and StorageGRID are the building blocks for private cloud deployments, enabling customers to bring public cloud-like experience and economics into their data centers. Our private cloud business, inclusive of products and services, attained an annualized net revenue run rate of $250 million in the first quarter, up 85% year-over-year.

Now, on to Cloud Data Services. In Q1, we achieved general availability with Microsoft, with Azure NetApp Files and beta release with Cloud Volumes Service for Google Cloud. Based on the last month of Q1, our annualized recurring revenue for Cloud Data Services increased to approximately $61 million, up 189% year-over-year. We continue to see a healthy mix of customers new to NetApp in our cloud services, and expect that cloud services will continue to enable us to reach new buyers and contribute to our acquisition of new customers.

We are very pleased with the initial ramp of Azure NetApp Files since becoming generally available. I'll share a customer example to illustrate why we're so excited. We are working with a Fortune 10 company to meet its cloud-first initiative, while delivering an equal or better experience to their on-premises environment with all the agility benefits of the cloud. The customer began testing Azure NetApp Files while it was in preview; and now that it's generally available, they have established a footprint of almost 2 petabytes and are growing by 100 terabytes per week.

While some of these data will migrate from existing NetApp systems, roughly two-thirds of the data they will move to Azure NetApp Files currently resides on competitors' storage systems. Our sales team partnered closely with the Azure team to leverage our expertise to help the customer establish their data strategy in the cloud. By working directly with the customer's cloud leadership, we have moved from being nearly an infrastructure provider with a minority position in the customer's data center to a key strategic partner. This is a great example of not only how our cloud strategy helps us expand our opportunity by displacing competitive footprint, but how also reaching new buyers, in this case the cloud team contributes to our growth. As I have described many times, customers and partners are choosing NetApp because of our Data Fabric strategy and our unique relationship with the hyperscale cloud providers.

Before closing, I would like to acknowledge and thank some long-time NetAppers, who are moving on for their contributions to our company, Tom Mendoza, Vice Chairman; Joel Reich, EVP Storage Systems and Software Business Unit; and Thomas Stanley, Senior VP of the Americas. We wish them all well. As we align to execute and thrive in a highly dynamic environment, change is inevitable.

To that end, I'd like to recognize two key promotions: Brad Anderson to EVP and GM overseeing both our Cloud Infrastructure and Storage Systems and Software Business Units; and Scott Allen to Chief Accounting Officer. I would also like to welcome Sanjay Rohatgi, Senior VP and GM of Asia-Pacific. I look forward to their contributions in the continuing evolution of NetApp.

I am confident in our strategy and the fundamentals of our business model. Our continued strong cash generation is a great example of the underlying health of our business. We remain committed to our capital allocation policy of returning cash to shareholders through share buybacks and the recently increased quarterly dividend. We will remain fiscally disciplined with our expenditures, while still investing for the long-term health of our business.

We consistently receive positive feedback from our customers and partners on the value of our Data Fabric strategy. And the strong performance of our best teams demonstrates our ability to capitalize on the strength. We are confident that we can return to growth by replicating their success in reaching more customers and buying centers with our full portfolio. We will keep you updated on the progress of these initiatives on future calls.

I'll now turn the call over to Ron. Ron?

Ronald J. Pasek

Executive Vice President & Chief Financial Officer, NetApp, Inc.

Thanks, George. Good afternoon, everyone, and thank you for joining us. As a reminder, I'll be referring to non-GAAP numbers, unless otherwise noted. To reiterate George's sentiment, we are clearly disappointed with the Q1 results and are committed to addressing the challenges we faced during the quarter. Despite the magnitude of our Q1 revenue shortfall, the gross margin and cost structure improvements we've made over the last three years provide support for our free cash flow generation. As a result, we remain committed to our capital allocation strategy of returning cash to shareholders through share buybacks and our recently increased quarterly dividend.

Before discussing our guidance, I'll provide further detail on our Q1 performance. In Q1, net revenues of $1.236 billion were down 16% year-over-year, including over 1 point of currency headwind. Product revenue of $644 million decreased approximately 26% year-over-year. As a reminder, the Q1 2019 compare includes $90 million of ELA revenues, which did not repeat this quarter. Adjusting for ELAs, Q1 revenue would have been down approximately 11% and product revenues would have been down approximately 18%.

Moving down the P&L. Software maintenance and hardware maintenance revenue of $523 million decreased 1% year-over-year and was flat when adjusting for currency. Deferred revenue, which was up 8% year-over-year in Q1, continues to be a strong indicator of the health of our installed base.

As we mentioned on the Q4 call and to provide greater insight into the dynamics of our business, we have updated our strategic and mature product view. Strategic product revenue includes add-on software, private cloud solutions and all products related to all-flash arrays. Mature product revenue now includes OEM and all products related to disk and hybrid arrays. A historical recast of the strategic/mature breakout can be found on our website.

As a reminder, cloud data services revenue is included in software maintenance. Gross margin of 67.2% was above the high end of our guidance range and includes approximately a 0.5 point of currency headwind. Product gross margin was 53.4%, which is an increase of 2.8 points year-over-year when adjusting for ELAs. The increase was driven by sales force discipline and cost reduction and includes nearly 1 point of currency headwinds. Q1 was the 10th straight quarter we increased product margin year-over-year when adjusting for the benefit of ELAs.

The combination of software and hardware maintenance and other services gross margin of 82.1% increased by 50 basis points year-over-year. Q1 operating expenses of $652 million were flat year-over-year. Operating margin was 14.4%. EPS of $0.65 was above the preliminary estimate we provided on our August 1 call, but below our original guidance range. We closed Q1 with $3.5 billion in cash and short-term investments.

Our cash conversion cycle was a negative 10 days, up 10 days year-over-year. DSO of 40 days was up 2 days year-over-year and down 30 days sequentially. The underperformance in revenue in the quarter drove DIO to 25 days, an 8-day increase year-over-year. We expect our cash conversion cycle to remain negative throughout fiscal 2020. Despite the revenue shortfall in the quarter, cash flow from operations was $310 million. Free cash flow of $278 million represented 22% of revenues and was up approximately 6% year-over-year.

During Q1, we repurchased 3.9 million shares at an average price of $64.87 for a total of $250 million, which is consistent with our planned run rate heading into fiscal 2020. Weighted average diluted shares outstanding were 243 million, down 26 million year-over-year, representing a 10% decrease. During the quarter, we paid out $115 million in cash dividends. In total, we returned $365 million to shareholders, representing 131% of free cash flow generated in the quarter. Our fiscal Q2 cash dividend is $0.48 per share.

Now on to guidance, as we discussed on our August 1 call, we expect revenues for fiscal 2020 to be down between 5% and 10% year-over-year. We continue to expect sequential growth within the year to be consistent with our normal seasonal patterns, except for the volatility introduced by ELAs. For fiscal 2020, we now expect gross margin to be in the range of 66% to 67%, above our previous guidance range of 64% to 65%, due primarily to the mix shift towards higher-margin maintenance revenues as a result of the weakness in product sales.

Operating margin for fiscal 2020 is expected to be in the range of 19% to 22%. Implied in this guidance is our expectation that operating expenses will be flat to slightly down year-over-year in fiscal 2020.

As George highlighted, we expect to add 200 head count to our sales coverage model over the next 12 months. As a result of the current revenue guidance, we expect EPS to be down between 2% and 15% year-over-year without the benefit of buybacks. Given the relative weakness of our Americas business in Q1, we now expect our effective tax rate to be approximately 18% and 19% in fiscal 2020. Additionally, we expect to continue to generate meaningful free cash flow in the range of 19% to 21% of revenues.

Now on to Q2 guidance. We expect Q2 net revenues to range between $1.325 billion and $1.475 billion, which at the midpoint implies an 8% decline in revenues year-over-year including over a point of currency headwind. For Q2, we expect consolidated gross margin to be approximately 66%, and operating margin to be between 18% and 19%.

We expect earnings per share for the second quarter to range between $0.91 and $0.99 per share. We are diligently focused on improved execution and addressing the challenges we face. We are committed to returning the company to growth, as we implement the action plan George outlined, and we remain confident our business model leverage will enable us to deliver long-term shareholder returns.

With that, I'll turn it back to Kris to open the call up for Q&A. Kris?

Kris Newton

Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

We'll now open the call for Q&A. Please be respectful of your peers and limit yourself to one question, so we can get to as many people as possible. Thanks for your cooperation. Operator? Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Nehal Chokshi of Maxim Group. Your line is open.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Thank you. You probably have covered this in the script, but your guidance does call for a significant improvement in the year-over-year revenue growth profile, and I appreciate all the detail on what you're doing to address the shortfall. Is it true to say that these things that you're doing, you expect to actually result in that improvement this quickly?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

If you look at our Q2 seasonality, there are sort of two or three elements that come into play. The first is Q2 is typically a strong quarter for our U.S. Public Sector business. The second is Cloud Data Services, and our private cloud business should continue to perform in a normal seasonal acceleration model. And then the third is that we have factored in and probably – probability weighted a little impact from ELAs in Q2. As you might note from the call script, we did not see any ELAs in Q1.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Understood. Okay. And then the deferred revenue continues to trend up year-over-year despite the significant year-over-year product revenue decline below even the July 2015 and July 2016 levels. Is it safe to say that this is a reflection of an increasing attach in software services per dollar of installed base?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

So it's a function of several things. That's one. It's also a function of we're doing a little better job on renewals and point-of-sale. The point-of-sale rate for services held steady. So, it's a focus area and has been for a while. We told you that. And we're doing a little better in it.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Okay, great. Thank you.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Nehal. Next question?

Operator: Our next question comes from Rod Hall of Goldman Sachs. Your question please.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Thanks for the question, guys. I wanted to start off, I guess, with the AFA weakness you called out George and see if – and yet it looks like, I mean, if we back that out the hybrid trajectory was okay. I mean, things seem more stable there. So I wonder if you could just drill into that in a little bit more detail, what you see going on there. Is it just a factor of this macro weakness? Or are you seeing people backing off of AFA investment but keeping up with hybrid?

And then I wanted to just double-check, just as a housekeeping measure. You're guiding with ELAs in the guide this quarter? Just want to check that, because I thought previously you guys had decided not to guide ELAs anymore, so. Thanks.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

Ron. So it's factored in with the probability. So there's some in there, and we factored it down a little bit, just in case, so – and there was some in there last year, so that's a fair compare. But we didn't put it in at the full value.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Can you guys...

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

With regard to the mix of AFAs and hybrid, if you recall last year, we had two elements that drove the AFA business. The first was we had several large global customers that purchased a lot of AFAs. And as we noted on our call, those customers are most impacted by the spending slowdown in hardware.

The second was that we also had about $90 million of ELAs last year and a good chunk of that was attributed to all-flash purchases. So those two onetime items on the compare was what drove the AFA number down substantially more than HFA. I would not say that there was any pattern of customers not choosing AFAs as opposed to HFAs in the broad demand environment.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. Thank you, George.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Rod. Next question?

Operator: Next question comes from Matt Cabral of Credit Suisse. Your line is open.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you. Just wondering if you can talk a little bit more about what's driving the uptick in gross margin guidance for the year. And in particular, just how we should think about the trajectory of product margins against just the potential for a pickup in the competitive environment if some of the slower deal environment lingers a little bit.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

Yeah. So there's a couple factors. The biggest one is, obviously, you can see that in the quarter as well, the product revenue was down year-over-year. So as a result, the services margin, which is higher than product, weighs higher on the overall margin and pushes the overall margin up.

Having said that, we've told you for the last several years, we're working on improving gross margins. We've had 10 consecutive quarters of gross margin improvement on the product margin side, and that should continue throughout the year a little bit, both from a pricing standpoint and then some comps as well.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I want to call out the good work done by our sales teams on maintaining discipline. I know that there are some people who think that there's a trade-off between revenue and margin. I think our teams have remained disciplined around the pricing environment. The strong gross margin indicates our competitive differentiation, and we have not walked away from revenue due to concerns about gross margin. We have strategically used gross margin and our business model as an opportunity where we've felt like it warranted it.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Matt. Next question?

Operator: The next question comes from Mehdi Hosseini of SIG. Your line is open.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Yes. Thanks for taking my question. George, going back to your comment on AFA, it seems to me that even if I were to exclude the ELA from FY 2019, the overall AFA revenue could be down in the high teen FY 2020 versus FY 2019. Is that a fair assumption?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

It is down a good amount. I think it is primarily due to our exposure from being very broadly deployed in big global strategic accounts that did not have as robust a spending pattern this year. The AFA business is the dominant business that we have in the big global customers, and they were the most impacted by some of the uncertainty that we saw with regard to macro.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thank you, Mehdi. Next question?

Operator: The next question comes from Andrew Nowinski of Piper Jaffray. Your line is open.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Great. Thank you. I just had a question on your OEM business. Last quarter, you talked about moving away from some OEM partners and focusing more on – more strategic partner such as Lenovo. I think the OEM revenue is included in the mature segment. So I was wondering, is that $307 million you did in mature this quarter in line with what you're expecting, or did you also see weakness at your OEM partners? Thanks.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

Yeah. We saw a little bit of weakness, and as you know it can be fairly lumpy. It's hard to predict oftentimes what OEM customers are going to buy. We feel comfortable with the outlook for the year for OEM, which as we told you last quarter is probably not as robust, and we're accepting that. But again, we didn't see a robust quarter this quarter. We do expect to make the year as planned.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

OEM is a small percentage of the mature category. It's frankly the smallest percentage of the mature category. We are driving focus on Lenovo, and it will take some time for that business to ramp. Once it ramps, it will stabilize the OEM revenue.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

All right, thanks.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Andy. Next question?

Operator: Next question comes from Katy Huberty of Morgan Stanley. Your line is open.

Kathryn L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Yes. Thank you. George, you talked about why your flash business in particular is down double-digits this quarter given the large enterprise exposure. What do you think the market for flash storage did in the quarter, is the market also declining? And then can you talk about how long it will take for the 200 new hires to reach their full sales quota? And what will be the funding source of those hires given you don't expect to grow OpEx? Thanks.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I couldn't comment yet on the overall flash market, Katy. I think that our view is that as NAND prices remain low, flash is a compellingly better technology than disk for a broad range of transactional applications. And so as a percentage of the mix, it should benefit from the fact that NAND prices are lower.

In terms of the head count that – so we're going to have to wait to see what other people report and sort of an overall market ramp-up to comment about flash. We think that in our case, the concentration of our largest customers also being our largest flash customers drove the sort of change in our flash business.

With regard to the investments, we're making in sales and primary demand creation head count, they're not all discrete quota-bearing head count. There are some technical sales head count as well. We are going to do that over 12 months. I think you will see us ramp through that period as we get operationally ready and deploy that sales head count. And so you should quarterize 200 over four quarters. And it typically takes us about three to four quarters to get them fully productive after they are on board.

Kathryn L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

With regard to what trade-offs we're going to make, listen, we've done a good job making trade-offs over the last several years. You can see that in our operating margins and gross margins, and we'll continue to make the appropriate choices to prioritize our investments into the biggest opportunity. We think we have a really good portfolio. And we think that based on the results we're seeing with our best teams, we can deploy more head count and capture more of the market footprint. And so we're going to stay disciplined around that.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Katy. Next question?

Operator: Our next question comes from Amit Daryanani of Evercore ISI. Your line is open.

Amit Daryanani
Analyst, Evercore ISI

Q

Yeah. Thanks a lot, guys. I guess, George, I was hoping you'd talk a little bit about how do you see the cloud services business ramping up through the fiscal year? And you were fairly positive I think on how the Azure ramp has gone, especially for GA, wondering how would you contrast the Google process as you go forward? And how do you think that will be comparable or different versus what's happening with Azure, especially given the fact Google, I think, bought something comparable in Elastifile recently?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

First of all, we are very pleased with the progress of our cloud services business. It's up 189% year-on-year. And I think the range of things that we see, the differentiation of our technology, the ability to migrate big customer workloads in a really cost-effective manner to the public cloud, and to be able to displace competitive footprint, they're all showing up. I think with regard to the plan of what we're executing to, it is to qualify more workloads and to get deployed into more data centers, that gives us a broader footprint of opportunity to go after.

To train the sales force, both the Microsoft sales force and the NetApp sales force, around selling these technologies in joint ways. And that will take time. These are big teams and it takes us time to get all of them trained. So, you should expect a ramp through the course of the year, getting stronger each quarter as more people are enabled.

With regard to Google, we think that we have as good an opportunity to migrate customer workloads to the Google Cloud. Elastifile is not a competitive product to what we have. It's a commodity offering to compete with the low-end file storage service. It's not an enterprise-grade file storage service. And so, we feel that our opportunity is undiminished. We are in beta and we are focused on the next step, which is to get to general availability. So far, what we see is similar pattern of customer trials, testing and so on. And so, we've done operational readiness with one cloud provider. We're going to work on the second. And then as we get to GA, we'll give you more details about it.

Amit Daryanani
Analyst, Evercore ISI

Q

Perfect. Thanks for the insights.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Amit. Next question?

Operator: Next question comes from Steven Fox of Cross Research. Your line is open.

Steven Fox
Analyst, Cross Research LLC

Q

Thanks. Good afternoon and thanks for all the color on the quarter. I'm just struggling a little bit with the assumption that some of the macro weakness is fairly compartmentalized around the large OEMs. Is there any other points or conversations you can point to rather that would say that you don't see further weakness in some smaller customers in Europe and the U.S. going forward? I'm just curious the confidence level in the macro at this point. Thanks.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think that our perspective on the macro is very similar to what is reflected in the public commentary on the markets. We saw weakness in certain parts of Europe, where GDP growth is challenged; for example, in Germany a little bit; and in the UK, where the sort of ongoing dialogue on Brexit is causing temporary pauses in spending. And then, we saw it in the global customers who we do a lot of business with. Right? I think, we did not say that the enterprises that were at the next tier down weren't exposed to the macro. It's our exposure to a particular customer is a lot lower when they're smaller. We have a diverse book of business in the smaller and midsized customers than in the giant global customers. So, I would tell you that what we experienced was a combination of macro and the big relationships that we have with some of these large global accounts.

Steven Fox
Analyst, Cross Research LLC

Q

That's helpful. Thank you very much.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Steve. Next question?

Operator: Next question comes from Lou Miscioscia of Daiwa Capital Markets. Your line is open.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.

Q

Okay. Thank you. I guess, George, if you could give us a view as to how, I guess, you viewed the sales operations since when you came in. I think that if we go back to 2015 when you first started, one of the options, I think, your predecessor had talked about was materially increasing the sales force because he viewed that as that would fix some of the problems. And I guess, the question I have and a bit of the difficulty I have is, here we are X number of years later, I realize the macro is very weak, so can completely understand that.

But you would think that the sales force would be at a run rate level now, after all these years, that you wouldn't have to go out and either; A, increase it, and I'm not saying that that's wrong; but also B, that there's a high level of ones that you talked about in the last call that were not at the appropriate productive level. I think we would be at a pretty good steady state. So, if you could just help us understand that. And maybe also a milestone or a number. You're adding 200, I mean, how big is the sales force? At least, maybe that will help us understand that statistically maybe why there's a couple of issues here. Thank you.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think, first of all, with regard to the work that we've done in the field organization, as we have said, we have transformed many elements of the field organization, particularly by implementing a coverage model that allows us to prioritize our resources against the biggest accounts and the biggest opportunities. We started the implementation of coverage against the big global accounts in a more systematic way two to three years ago, which is what drove the results that we had alongside the big global accounts. We don't cover 100% of the largest 2,000 to 3,000 accounts in the world. And we believe given the results that we've had that we have the opportunity by expanding coverage to a broader set of accounts that we can grow our business.

We have also implemented new selling motions, right, like covering certain markets through the channel. You saw us restructuring parts of our European organization so that we could afford the investments in covering the bigger accounts in the bigger countries by moving some of our countries, approximately 15 of them to be served through the channel. We have constructed a joint venture in China together with Lenovo so that we could participate in the China market in a more efficient fashion.

So, we've do a lot of things to change the structure and the composition of the sales force. We think that by adding a combination of resources to go after the market approximately 8% to 10% increase in coverage, we should be able to continue to grow our business in the top line, which is the fundamental issue we've had.

If you look at the rest of the P&L, we've had an exceptionally strong result across gross margin, operating margin and all of the other elements of cash generation. And we think that this is specifically a top line issue. We think that by broadening our coverage and footprint, we should be able to mitigate the impact of the macro on a few large customers that today we are exposed to.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.
Q

Okay. Thank you.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.
A

Thanks, Lou. Next question?

Operator: The next question comes from Tim Long of Barclays. Your line is open.

Timothy Patrick Long
Analyst, Barclays
Q

Thank you. If I could just ask kind of a two-parter here on visibility. Obviously, what happened last quarter took you a little bit by surprise. Can you just talk a little bit about this full year view and how you feel about the second half? And did you do some factoring of kind of pipeline like you did for the ELAs in the quarter? And then just, Ron, if you can remind me the visibility into the installed base, I get that the deferred rose, but we did have a decline in a few of the revenue lines, the product services and hardware maintenance. So if you could just flush out for us that installed base view, that will be great. Thank you.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.
A

Yeah. So let me start with that one. So when you look at maintenance, you've got to kind of combine the software maintenance and hardware maintenance together, as we've changed the value associated with each over a period of time; certainly, as it relates to the newly installed base.

When you add them together, they're down 1% year-over-year; when you adjust for FX, they're flat. The fact of the matter is we are growing our installed base as systems under contract and have been for really – for the last eight quarters. So it's actually very healthy, what you see reflected in the deferred revenue number.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.
A

With regard to our outlook for the rest of the year, we are not expecting a rapid resolution of either the macro or some of the uncertainty around trade, and so we factored in a fairly conservative profile and outlook in the overall picture. It is reflective of typical linearity based on a very slow start in Q1. And it includes some of the fact that our second half has an easier compare compared our first half of this year. And so we're not expecting some miraculous rebound in terms of the macro environment.

I think with regard to ELAs, as we said ELAs comprise about 2% of the total revenue in a year. We don't break it out on a per quarter basis. You should factor in some sort of run rate for ELAs within our broader guidance.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.
A

Just to add to that, Tim, remember we have no ELAs in Q1, limited in Q2, so most of the ELAs will happen in the second half. Actually, it helps with the second half number.

Timothy Patrick Long
Analyst, Barclays
Q

Okay. Thank you.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.
A

Thanks, Tim. Next question?

Operator: Next question comes from Jim Suva of Citigroup. Your line is open.

James Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thanks very much. Ron and George, a quick question for each of you. Ron, you just mentioned limited ELAs next quarter and then more in the second half, if I heard that correctly. And when you say more in the second half, do we think then about an annual run rate that you've been talking of, or how should we think about the ELAs in the second half?

And then, George, if you can just help us understand, adding 200 sales people in America, that's very good, and a couple of quarters to ramp. But I think I heard you say no additional expenses. So, how does that work out? Is that just a reallocation, or how do you work out more people with no additional cost?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.
A

Yeah. So just on the ELAs, I won't give you the number in Q2, but it's not huge. Obviously, I factored it down, which means that most of the ELAs will be in the second half. Again, to George's point, we told you that ELAs are roughly 2% of total revenues, so you should expect the majority of that in the second half of the year.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.
A

With regard to the sales capacity, as I said, they're not our primary quota-bearing head count. The majority of the 200 should be quota-bearing head count, but it's a combination of front line quota-bearing head count, technical resources and management. We are going to deploy them in a graded fashion over four quarters. And you should expect a ramp through those quarters as we get the operational momentum of hiring and all of that in place. It takes three to four quarters, as we've said consistently, for a sales rep to get productive, right? And some of these are going to be focused on selling our private cloud and public cloud portfolios, which have a different business model or profile than a traditional storage system.

With regard to how do we expect to hire 200 people and not impact operating expenses, I'll just say, we have north of 10,500 people on the company payroll, and so we'll make the appropriate trade-offs across our broader employee population as we think about people who lead the company and the shape of people we hire, we'll shape it towards the sales organization so that we can accelerate the turnaround.

James Suva
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you so much for the details and clarification. That's great. We appreciate it.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

Thank you, Jim.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Jim. Next question?

Operator: Next question comes from Aaron Rakers of Wells Fargo. Your line is open.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yeah. Thanks for taking the question. I want to go back to Amit's question earlier on the Cloud Data Services business. First of all, just a kind of clarification relative to what you said on the pre-announcement now today, are you endorsing the fact that you still believe you will be at that $400-plus million run rate exiting fiscal 2021?

And then kind of building on that, one of the comments in the prepared remarks is that CDS is ramping and there are some elements of cannibalization to the traditional business. I'm trying to understand how you think about that. Should we consider that as CDS ramps, there's going to be some cannibalization of the traditional on-premise business for you guys? Just any kind of clarification or help on that would be useful.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

First of all, I think we are pleased with the momentum that we have in the CDS business. We still have the plan to be in the $400 million to $600 million annual recurring run rate exiting Q4 of fiscal 2021, and we're executing to that plan. There's a lot of work that goes into that, but having a leading hyperscaler like Microsoft now generally available is a good benchmark. And the next benchmark is to scale them as we get Google Cloud Platform to general availability. So we're heads down in executing our game plan.

I think with regard to the pace of customer adoption, we feel very good about the early results, right? And I think that you should see that ramp through the course of the year.

With regard to cannibalization, I would just tell you that the fact that NetApp technology is available in the Microsoft Cloud or the Google Cloud doesn't necessarily mean that the customer is going to move the NetApp workloads first to the cloud. They have a pattern of workloads they want to move to the cloud. We get to participate in a much broader opportunity as a result of having our technology now being the enterprise platform for both Microsoft and Google at the expense of our competition, right? That loses every dollar that moves to the cloud, they're going to get zero. We get to participate in two of the biggest hyperscalers now capturing those workloads onto our platform.

Does it, on the margin, cause some cannibalization? That's already factored into the on-premise business versus the public cloud business forecast that people have. We just now get to participate in a much more meaningful way in the public cloud business than anybody else. And in some ways, that is also helping us now with new footprint on-premises as customers now say, listen, I discovered NetApp in the public cloud, I want to give him a bigger footprint on-prem.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Very helpful. Thank you.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Aaron. Next question?

Operator: Next question comes from Ananda Baruah of Loop Capital. Your line is open.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Good afternoon. Appreciate you taking the question. Yeah, just going back to AFA, I guess, just a quick two-parter for both George and Ron, if I could. I would love to get a sense of, as you're seeing incremental pricing pressure over the last couple of quarters in AFA, even if it's from the customers, has the deal sizes had shrunk a bit? And then just sticking with AFA, I wanted to get a sense of if you think that macro aside, just industry penetration, the velocity of industry penetration has been slowing at all? And your thoughts around that. Thank a lot.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I tell you, what we saw with our AFA business is that customers bought more of the midrange configurations and bought the capacity that they needed for the next year rather than rightsizing the equipment for a three-year outlook, right? And that is what I would do if I were faced with an uncertain budget environment. So we did see that fairly systematically. I think with regard to AFA versus the overall storage market, I think that the economics of AFAs compared to hybrid continues to grow and get better, right? If you look at NAND prices, they continue to make AFA a much more attractive value proposition than they were in the past every quarter. And so if I were customer, I would continue to prioritize AFA for all my transactional applications. The overall landscape for storage is dependent on the macro. And so I don't see the mix changing. I just look at the overall water level being determined by the macro.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Okay, got it. That's helpful. I appreciate the context. Thanks.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

All right. Thanks, Ananda. Next question?

Operator: The next question comes from Eric Martinuzzi of Lake Street. Your line is open.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Yeah. I just wanted to clarify. A couple of weeks ago, you talked about the shortfall being about two-thirds macro, one-third NetApp-specific. Wanted to make sure that was – you still felt that was the case after a couple of weeks of analysis. And then second part of the question has to do with you've turned over your EVP, Americas. Wondering if there's any turnover below that at senior level because obviously that will make the – adding to the sales more of a back-end loaded 2020 effort. I would think that might slow things down on the sales hiring.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

Listen, I think that our analysis leads us to draw the same conclusion, which is it's two-third macro; one-third, yes, we could have executed better. We did see some exposure from our being concentrated in some of the larger accounts, right? And I think that that's consistent. I want to just say that our leadership team, we wish all of the members of our leadership team well. We have the need to continue to add capacity. That's the fundamental area of focus for us. We'll continue to make – inspect our business and we'll provide you updates on our execution improvements over time. I'll just leave it there.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

But were there second-level turnover? Obviously, there was at the EVP level, but kind of one level down from that?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

No.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Okay. Thank you.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thanks, Eric. Next question?

Operator: Next question comes from Andrew Vadheim of Wolfe Research. Your line is open.

Andrew Vadheim
Analyst, Wolfe Research LLC

Q

Thank you. I wanted to follow up on the full year outlook and what role macro plays. So, if we look at 1Q, regarding the geographic breakdown of your reps, especially focusing on EMEA and APAC, weren't your numbers were pretty close to our expectations? And if we look at geographic split back to your full year guide, are you betting sort of a flat or slightly down EMEA and APAC for the year? And then uncertainty in Americas gets you to down 10% at the low end to down 5% at the high end, or does the bottom/top of the range embed a bull-bear case for EMEA and APAC?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

I'd rather not go into some of specific assumptions we've made by geo. I think we did look at several things. We looked at what we're seeing in the macro environment in each of those geographies. We talked a little about sales leadership, et cetera, or making judgments overall. So I can't tell you the exact trade-offs we made, but we're looking at the down 5% to down 10% for the year. So, obviously, you'll see that probably most profoundly down in the Americas, given where we are. But beyond that, I'm not going to give any other detail.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I'll just say, I think all of the calculations and factors we considered are in the public domain, right? And we use those factors to determine broad-based economic trajectories, and then combine that with the judgment and the pipeline data of our sales teams, and the historical linearity pattern of our business.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

All right. Thank you, Andrew. Next question?

Operator: Next question comes from Nik Todorov of Longbow Research. Your line is open.

Nikolay Todorov
Analyst, Longbow Research LLC

Q

Hi. Thanks for taking the question. You guys talked about customer concentration a couple of times today. Can you give us a little bit more color, maybe an example of how much revenue your top 10 or 15 customers account for?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

We're not going to break that out. I would just say that the impact of what happened during the quarter was primarily due to the fact that some of our largest global accounts that we have very strategic relationships with did not spend anywhere close to what they spent last year. I'll give you an example. We had two large customers that are exposed to the China tariff situation that have cut their capital spending by north of 30% year-on-year. Clearly, we are a part of that spending profile. And so, I would just say that we have really good relationships with the big set of customers, and we're planning to broaden those relationships to another broader set of customers over the course of the next year to 18 months.

Nikolay Todorov
Analyst, Longbow Research LLC

Q

Okay. And can I squeeze one more in? Can you remind us how much you have remaining on your buyback authorization? And that will be it for me. Thanks.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

We have $1.6 billion left on the authorization.

Nikolay Todorov
Analyst, Longbow Research LLC
Q

Okay. Thanks, guys. Good luck.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.
A

Thanks, Nik. Next question?

Operator: Next question comes from Simon Leopold of Raymond James. Your line is open.

Simon Leopold
Analyst, Raymond James & Associates, Inc.
Q

Thank you. During the prepared remarks, you did indicate that you're not seeing any change in the competitive environment. I just wanted to maybe get a better understanding of whether or not we might see some market share shifts as measured by the third-party that might reflect differences in geographies or differences in terms of footprint where maybe a competitor might be upgrading its legacy footprint and you've completed that task. Just trying to get a little bit of better understanding of how you could be confident that it's not about competition and how to square this with third-party research. Thank you.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.
A

I think that what we mean when we say it's not a competitive factor is that our win rates in competitive transactions remains the same. Our product gross margins were up 280 basis points year-on-year when you adjust for ELAs, which shows the strength of our differentiation, right? I think there may be differences in how the results play out for different providers, depending on their customer bases. We did see exposure from our biggest customers not buying as much, right? And I think that what we are convinced of is that if we expand our footprint and broaden our customer coverage, given the strength of the performance we've had in the places where we saw budget available and our ability to win competitive transactions, we should be able to broaden our book of business and reduce the effects of customer concentration.

Simon Leopold
Analyst, Raymond James & Associates, Inc.
Q

Thank you for the clarification.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.
A

Thank you, Simon. Next question?

Operator: Next question comes from Mehdi Hosseini of SIG. Your line is open.

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

Yes. I have two follow-ups. Ron, if I were just to look at your guide for the October quarter operating margin, it seems to me that the OpEx would actually go up by $10 million to $15 million. Is that fair assumption?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.
A

Yeah. I mean, it goes up as a function of revenue, sure.

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

Okay. So just going back to the comment of adding additional salespeople, this OpEx is just nature of the revenue, nothing to do with the sales force?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.
A

Yeah.

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

Okay.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.
A

You won't see a huge impact to OpEx in the quarter for the hiring. It takes a while to get people on board. You'll see some increases baked in there, but most of that's just a function of the linearity throughout the year, linear revenue and the head count structure. So...

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

I just had a quick follow-up to the AFA question I asked earlier. Your comments suggest that there is a high-teen decline in AFA revenue FY 2020 versus FY 2019. But as I look at the back half of this FY 2020, I see a nice rebound driven by the migration of a 10K RPM to SSD and that should build momentum into calendar year – into the fiscal year 2021. Is that a fair assumption as to what could drive a rebound in AFA?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.
A

I think, first of all, what we said was it was reflective of Q1 results, Q1 FY 2020 over Q1 FY 2019 being down in the high teens, right? I think with regard to the rest of the year, I'm not going to break out AFA versus HFA. I think that AFA is advantaged on a whole bunch of dimensions and should continue to get a bigger share of the pie of storage relative to HFA than it was in prior years just because of NAND economics, QLC, all kinds of things. I think we will continue to use every opportunity we can to drive transition of disk-based systems and hybrid-based systems to all-flash systems. The pace of those upgrades is a combination of, yes, good technology being available, but also budget cycles being available. And so, we're going to lean in on the technology side and give customers every opportunity to upgrade. But we'll have to wait to see how the macro plays out to see how many of those budget cycles are available.

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

Got it. Thank you.

Kris Newton
Vice President-Corporate Communications and Investor Relations, NetApp, Inc.

A

Thank you, Mehdi. I'll now pass it back to George for a couple of closing comments.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. I'm disappointed in our weaker-than-expected top line results, but I remain confident that we have the right strategy and technologies to address the key market transitions. We have a strong business model as the result of the hard work we conducted to improve gross margin and cost structure over the last several years. Our continued strong cash generation is a great example of the underlying health of our business. We'll remain fiscally disciplined with our expenditures, while still investing for the long-term health of the business. And we remain committed to our capital allocation policy of returning cash to shareholders through share buybacks and a quarterly dividend. The robust fundamentals of our business enable us to navigate the ongoing macroeconomic headwinds and make the strategic moves that position us to return to growth.

I hope to see you at the Investors section of our Annual Insight User Conference on October 29 in Las Vegas. Thank you again.

Operator: Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may disconnect your lines at this time.